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Liabilities of Organizers, Members and Officers of a Private Corporation in Indiana (Pt. 2)

Robert W. Miller
Harvard Law School

LIABILITIES OF ORGANIZERS, MEMBERS AND OFFICERS OF A PRIVATE CORPORATION IN INDIANA—II

ROBERT W. MILLER*

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DIRECTORS AND OTHER OFFICERS

Since the corporation is not a natural person but only an association existing in the eyes of the law, it must rely upon agents to carry on its business. As a general rule the charter of the corporation provides what officers and agents will manage the company's affairs, such management usually being vested in a board of directors elected at stated intervals by the stockholders of the company, such directors in turn appointing other officers and agents.[62]

The first question which naturally arises under this heading is as to who are liable as corporate officers. Where there has been no acceptance or user, either expressly or impliedly, of the office, the person sought to be held should be excused. Hence, it follows, that those persons who are liable must be corporate officers at or during the time of the omission or commission of the act relied upon as creating liability.

Having both a corporation and corporate officers, it is then important to determine the legal relationship of the two. A few cases have considered this question at great length, most of the later decisions holding that a director or other corporate officer is a trustee as regards the corporation. The truth, however, is that though the relationship is a fiduciary one, still the analogy of trustee and cestui que trust is not exact, a distinct legal status being created, which, in a number of ways, resembles that of a trustee.

Conceding that corporate officers occupy a fiduciary relationship to the corporation, the extent of their liability to the corporation can next be discussed. The directors and other officers of a corporation incur, to a large extent, the same liability, the

* See biographical note, p. 193.

62 In the absence of statute or provision in the charter to the contrary, directors or other corporate officers need have no particular qualifications. Although generally required to be a stockholder, there is no rule of law which requires ownership of stock as a condition precedent to the right to be a director or officer.

same rules usually applying to both.[63] A rule of first importance is that the corporate officers must exercise the utmost good faith in all transactions which involve their duties to the corporation and its property. This does not mean that the obligations of the corporation's contracts must be personally carried out by them, but only that good faith on their part must exist as regards corporate transactions. Hence, where a corporate officer diverted corporate property by pledging it to secure the payment of his individual debts, he became liable to the corporation for such diversion on the grounds of acting with bad faith.[64]

Directors are liable if they permit the corporate funds to be lost or wasted by reason of their negligence and inattention to their duties, though such losses occur without actual bad faith on their part. What care must corporate officers exercise? The best rule seems to be that negligence is the want of care according to the circumstances, and the circumstances are everything in considering this question. One thing certain, however, is that the corporate officers must be something more than mere figureheads. What is required is a reasonable degree of business knowledge, care and diligence, under the circumstances of the particular case.[65]

Having seen that corporate officers must act with good faith and with reasonable prudence, must all their acts be for the benefit of the corporation or may they also act for their own interests? Being officers and agents for the corporation, it would seem that their acts must be solely for the benefit of the corporation except where there is no specific duty on the part of such officers. In such latter case, it seems only fair that corporate officers may acquire outside interests, although the corporation may be more or less interested. This question arises primarily where the officer attempts to and does buy up outstanding claims against the corporation. In such a case, it is usually held that the officer may buy up the claim and later

63 Due to the fact that active officers receive compensation and spend more of their time on corporate matters, their liability may be more extensive than that of the directors.

64 *Crawfordsville First National Bank v. Dovetail, etc. Co.* (1895), 143 Ind. 534.

65 There has been considerable conflict on this question and authorities have held differently at different times. Some courts have held that bad faith was necessary before any liability was incurred. Other courts have had the rule of honest judgment. Still other views have been held, but the rule that the corporate officer must live up to the duties of his job, such duty to be determined by the circumstances of each case, seems much fairer.

enforce it as against the corporation.[66] Another place where the question arises is where a director or other corporate officer seeks to purchase at an execution or judicial sale. The better view permits the corporate officers to buy in such corporate property if the price is a fair one and there is good faith exhibited throughout the entire transactoin. In these cases, however, there is no specific duty resting upon the corporate officers to act for the best interests of the corporation.

Since corporate officers occupy a fiduciary capacity towards the corporation, it follows that they are not permitted to profit, in their individual capacity, by virtue of their position. Hence, any profits so received by them, due to their being officers, belong to the company and an action by the company may be had against them for such profits.[67] This does not mean that a corporate officer cannot contract with the corporation, but does mean that where he does so contract that certain safeguards must be provided in order to make such contract valid.[68] Hence, in general, we may say that a director or other corporate officer must account to the corporation for any and all profits accruing to him individually due to the fiduciary relationship in which he stands to the corporation.

The cases seem to hold that directors are not liable for the acts or omissions of other directors or agents, where such directors have not themselves been guilty of neglect in supervising or appointing them. But where such directors have participated in such acts, or negligently failed to take measure to prevent them, liability for resulting acts attaches. Directors "are not

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[66] There is a conflict in the decisions where the officer buys the claim at a discount and seeks to enforce it for full payment against the corporation. Where the corporation was in the market itself, i. e., had set aside a special fund to buy in such claims, etc., the better rule seems to hold that the officer may recover only the amount he paid for such claim and can make no profit on such transaction.

[67] Where a director or other corporate officer in his dealings on behalf of the corporation, either expressly or otherwise makes a profit not enjoyed by the other stockholders, a duty to account arises. *Tevis v. Hammersmith* (1907), 170 Ind. 286.

[68] Where a director or other corporate officer contracts with the corporation, the mere fact that such person is an officer of the corporation does not *ipso facto* render the contract bad, where the transaction is not unfair to the corporation and the officer has acted in good faith. *Wainwright v. P. H. & F. M. Roots Co.* (1912), 176 Ind. 682. Unless the following safeguards are had, the contract is considered voidable: (1) Good faith, (2) disinterested quorum, and (3) non-participation by the interested corporate officer. New Jersey requires, in addition, the approval of the stockholders.

insurers of the fidelity of the agents whom they have appointed, who are not their agents, but the agents of the corporation; and they cannot be held responsible for losses resulting from the wrongful acts or omissions of other directors or agents, unless the loss is a consequence of their own neglect of duty, either for failure to supervise the business with attention, or in neglecting to use proper care in the appointment of agents."[69] The Supreme Court of Indiana, speaking through Justice Dowling, sums up: "The supervision of the directors over the business of the bank should have been such as would have enabled them at all times to know its general financial condition, and to check or prevent improvident or dishonest conduct by the president or cashier. They had the means of knowing, and they were bound to know the amount and value of the paper and securities held by the bank. They were also bound to know the character and habits of the men they had placed and kept in charge of the bank as its president and cashier. There could be no excuse for their failure to examine the books of the bank, and for their ignorance of the manner in which the business was conducted."

A director or other corporate officer is liable to the corporation for losses sustained by it where he acts outside the scope of his authority. In the case where the question of ultra vires acts of corporate officers arises, it is material that such officers should have known that the acts in question were ultra vires or expressly forbidden or beyond their powers. If the act is illegal or ultra vires, liability attaches if it is reasonable to believe that such corporate officers should have known they were exceeding their authority.

Briefly summarizing the liability of corporate officers to the corporation we find that they owe a duty to the corporation of managing the corporate affairs honestly and impartially for the benefit of the corporation and stockholders. They are liable for losses caused by wilful and intentional violation of their duties, for negligence, ultra vires, acts, etc. They are not, however, liable for losses happening through mere inadvertence and mistakes of fact, having acted in good faith, with prudence and in the exercise of their honest judgment.

Having considered the liability of corporate officers as regards the corporation, we next turn to their liability to the stockholders. A fiduciary relationship exists between the corporate officers and the stockholders as a group, but such officers cannot,

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[69] *Briggs v. Spaulding* (1891), 141 U. S. 132.

in any sense, be considered the agents of the individual stockholders, nor does the fiduciary relationship extend to the individual stockholders. Chief Justice Shaw said: "There is no legal privity, relation or immediate connection between the holders of shares in a bank, in their individual capacity, on the one side, and the directors of the bank, on the other. The directors are not the bailees, the factors, agents, or trustees of such individual stockholders."[70]

It has been decided that an action at law, by the stockholders against the directors, cannot be maintained for fraud, negligence, misapplication of funds, or other wrongs resulting in injury to the corporation. Such an action is reserved to the corporation to whom the injury is primarily done. The mere fact that the value of the shares are incidentally decreased does not give the stockholder a cause of action. It is only where the corporation refuses to sue upon due application by the stockholders that the stockholders may sue on behalf of the corporation. But a demand where such a demand may awaken the conscience of the corporation, is a condition precedent to the stockholder's right of action.[71]

The main question arising as between corporate officers and stockholders relates to the duty of the director in purchasing stock from the stockholder. May he treat the stockholder as a stranger? There seems to be split of opinion on this question. One Indiana Court held thát directors may trade like strangers provided they do not affirmatively act or speak wrongfully, or intentionally conceal facts with reference to it.[72] Seemingly a better rule would be to require the directors to disclose at least the salient facts and state his position to the corporation, the directors and stockholders not, in truth, being absolute strangers. The law on this point is not settled, as shown by a recent case, where the director was also the general manager of the corporation as well, the United States Supreme Court holding that a fiduciary relationship existed.[73] Certainly it is fallacious to hold that dealings should be had on the same basis as if both parties were absolute strangers.

Having considered the liability of the corporate officers to the corporation and stockholders, their liability as regards third persons and creditors logically follows. There is a conflict of

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[70] *Smith v. Hurd,* 12 Metc. (Mass.) 371.

[71] *Tevis v. Hammersmith* (1903), 31 Ind. App. 281.

[72] *Tippecanoe County Comm'rs v. Reynolds* (1873), 44 Ind. 509.

[73] *Strong v. Repide,* 213 U. S. 419.

opinion as to whether a director is a trustee for the creditors and the better answer to this inquiry is to place insolvency as the dividing line, holding directors as trustees after insolvency.[74]

Considering the liability of corporate officers as regards contracts, as seen before, no liability attaches on a contract where both parties understand that the contract is with the corporation. Of course, by express agreement, a director may make himself personally liable on a corporate contract, but such is not the usual case. On the other hand, where the officer enters into the contract without disclosing the fact that he is acting for the corporation, but upon the assumption that he is acting for himself as an individual, the other party to the contract may elect to hold either the corporation or the officer, but not both. But if the other party knows of the agency or should have known, then only the corporation, is bound and not the agent. If the contract is entered into in the name of a pretended corporation, one nakedly assuming to be a corporation, the rule of individual liability is applied. Hence, the status of the corporation and the basis upon which the officer entered into the contract must be considered in determining the liability involved.

Where a contract is entered into for the benefit of and in the name of the corporation by the corporate officer, but such is done in excess of his authority and without ratification by the corporation, the second party to the contract being in ignorance of the officer's want of authority, such renders the corporate officer personally liable either on the contract, or, in other jurisdictions for false warranty of authority.[75] But an exception is had if the second party to the contract is chargeable with knowledge.[76] There is a hopeless split of opinion on the point as to whether liability results in favor of persons contracting with the corporate officers as representatives merely because the contract entered into is ultra vires.

Besides liability to third persons on contracts, a liability also exists for tortious acts. In the field of corporations, as well as

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[74] *City National Bank v. Goshen Woollen Mills Co.* (1904), 35 Ind. App., 562.

[75] *Flick v. Jordan* (1920), 74 Ind. App. 314.

[76] *Sourwine v. McRoy Clay Works* (1908), 42 Ind. App. 358. "Where one person acting for another holds himself out as having authority to do an act, and thereby draws another into a reciprocal engagement, he will be liable if he acted without authority; but if such want of auhtority was known to both parties or unknown to both parties—there being a mutual mistake— the agent would not be liable." This is applicable to corporations. *Newman v. Sylvester* (1873), 42 Ind. 106.

in any other field, a man is personally liable for all torts committed by him. Hence, corporate officers are liable to third persons for injuries inflicted, regardless of whether the act was done on his own account or on behalf of the corporation, ratification of the tort by the corporation in no wise affecting this personal liability.[77] In the absence of a statute to the contrary, this liability of corporate officers is generally imposed only in the cases of misfeasance or malfeasance, a split of opinion being had on the question of nonfeasance, the majority courts excusing such officer from liability.[78]

The typical case in which the tort liability of an officer is involved is had in the case of fradulent acts and representations to persons who are injured thereby. Such officer is personally liable for damages caused by this fraud and deceit to the person so injured. Likewise, where there is an appropriation of the corporate property, conversion of its assets, or a negligent and bad faith declaration and payment of dividends out of capital, etc., a cause of action, sounding in tort, may be had against such corporate officers.[79] A direct action may be brought by such third persons against the officer or officers where the cause of action is personal. Where the injury, however, is to the corporation primarily, so long as the corporation is solvent the creditors have no right to enforce corporate claims. After insolvency, however, and on refusal of the corporation to act, creditors may sue in the right of, and on the behalf of, the corporation to enforce its cause of action against officers or directors who are liable to it.[80]

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77 *Farmers' Mutual Fire Ins. Ass'n. v. Stewart* (1906), 167 Ind. 544, and *Wright v. Barnard* (1917), 248 Fed. 756. An officer or director of a corporation is not liable for its torts where no participation, knowledge or consent on his part has been had in the transaction. The converse of this is also true. *Hartzler v. Goshen Churn Co.* (1913), 55 Ind. App. 455. Participation in the tort is essential, unless there be consent or authorization, in order to hold an officer liable for the torts of other officers. *Folwell v. Miller* (1906), 145 Fed. 495.

78 Majority view—*Baltimore Nat'l Bank Exch. v. Peters* (1890), 44 Fed. 13. Minority view—*Va.-Carolina Chem. Co. v. Ehrich* (1916), 230 Fed. 1005.

79 *Munro v. Smith* (1919), 259 Fed. 1; *Moore v. Murchison* (1915), 226 Fed. 679.

80 The question as to the rights of creditors who became such after the transaction complained of will not be discussed in this article. Fletcher's *Cyclopedia Corporations* is given for reference. Other questions of procedure as to whether the creditor's remedy is in law or equity, etc., will also not be discussed here.

So far the liability of corporate officers has been discussed without much reference to statutes. In a number of states statutes have been enacted which make the directors or other corporate officers liable for its debts where they are guilty of certain prescribed official neglect or misconduct. Fletcher in his Cyclopedia Corporations has roughly attempted to classify these statutes, although an exhaustive classification is practically impossible.[81] Where the Legislature has acted by way of statute in imposing liability upon directors and other officers for corporate debts, such statutes may be construed as being penal in character.[82] It is sufficient to say that where a statute imposes a certain duty upon a director or officer, and prescribes a penalty for its non-performance, such duty as laid down is the test of both the liability and standard of conduct imposed and required.

In addition to civil liability being imposed, there is nothing to prohibit a corporate officer from being criminally liable for his acts; the fact that his act being an official one not constituting a defense.[83] Hence, where an officer conspires with other officers to convert corporate funds to their own use, an action of embezzlement might be had against them. Indiana, for example, imposes a criminal liability on officers wilfully failing or refusing to make reports.[84] As a general rule, criminal liability is a statutory matter, hence an examination of the statutes of the

81 (a) Statutes creating liability where statutory conditions precedent to the right to do business have not been complied with or where all of a certain part of the stock has not been subscribed for or paid in. *Brown v. Clow* (1901), 158 Ind. 403. (b) Statutes providing that the violation of any of the provisions of the incorporating act; or of certain preceding sections act, shall make directors or other officers personally liable. Burns' Statutes (1926), Sec. 5522, as regards Manufacturing and Mining Companies. (c) Statutes making officers liable to creditors, or creditors and others, for negligence or other breach of duty. (d) Statutes creating a personal liability where the debts exceed a certain amount. *Schofield v. Henderson* (1879), 67 Ind. 258. (e) Statutes making directors and others personally liable for failure to file annual reports. (g) Statutes making corporate officers personally liable for false reports, certificates, statements, notices or the like.

82 Statutes creating personal liability of officers of a corporation are generally held to be penal in character, although not such in the strict sense of the term—*Brown v. Clow* (1901), 158 Ind. 403; and are to be strictly construed, *Raber v. Jones* (1872), 40 Ind. 436.

83 *State v. Cooley*, 141 Tenn. 33.

84 *State v. Cox* (1882), 88 Ind. 254.

various states would be necessary to make an exhaustive study of acts for which criminal liability is imposed.

The attempt made in this article has been to enumerate a few of the many duties and liabilities imposed upon the organizers, members and officers of private corporations with special reference to the Indiana statutes and decisions. Certainly a new corporation act can do much to reform this field of our law.

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